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Proposed statement of position : Reporting funds flows, liquidity, and financial flexibility for banks ;Reporting funds flows, liquidity, and financial flexibility for banks; Exposure draft (American Institute of Certified Public Accountants), 1985, Oct. 1

American Institute of Certified Public Accountants. Committee on Banking

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

REPORTING FUNDS FLOWS, LIQUIDITY, AND FINANCIAL FLEXIBILITY FOR BANKS

OCTOBER 1, 1985

Prepared by the Committee on Banking
American Institute of Certified Public Accountants

Comments should be received by January 2, 1986, and addressed to
Maryn H. Fisher, Technical Manager, Federal Government Division
AICPA, 1620 Eye Street, N.W., Washington, D.C. 20006

SUMMARY

The proposed statement of position recommends certain changes in the traditional format and presentation in statements of changes in financial position for banks in order to provide more meaningful guidance to accountants and bankers on this subject. The proposed statement of changes in financial position emphasizes financial resources invested in earnings assets. Related banking activities are presented together as financial resources provided by (1) operations, (2) deposits and other financing activities, and (3) nonearning investments of financial resources. The proposed statement of changes in financial position is based on changes in year-end balance sheet amounts rather than average balances. In addition to specific recommendations concerning form and content of banks' statements of changes in financial position, the proposed statement of position suggests additional types of explanatory disclosure that would not be embodied in the basic financial statements, but would help the reader better understand the interest rate sensitivity and funds management of banks. Exhibit 2 of the proposed statement of position contains a suggested table for presenting interest rate sensitivity information of banks.

The committee would appreciate comments concerning the recommendations for the format of banks' statements of changes in financial position and the supplemental disclosure of information on liquidity and financial flexibility.

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas New York New York 10036 (212) 575 6200

October 1, 1985

Accompanying this letter is an exposure draft of a proposed statement of position, Reporting Funds Flows, Liquidity, and Financial Flexibility for Banks. A summary of the proposed SOP also accompanies this letter.

Comments on this exposure draft should be sent to Maryn H. Fisher, Technical Manager, Federal Government Division, AICPA, 1620 Eye Street, N.W., Washington, D.C. 20006, in time to be received by January 2, 1986. Responses will be helpful if they refer to the specific paragraph numbers and include reasons for any suggestions or comments.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the Washington office of the American Institute of Certified Public Accountants after February 3, 1986, for one year.

Sincerely,

Roger Cason

Roger Cason
Chairman
Accounting Standards Executive Committee

J. Thomas Macy

J. Thomas Macy
Chairman
Committee on Banking

Accounting Standards Executive Committee

(1984-1985)

Committee on Banking

(1984-1985)

REPORTING FUNDS FLOWS, LIQUIDITY, AND FINANCIAL FLEXIBILITY FOR BANKS

1. Most banks report changes in financial position using the traditional format showing financial resources provided by operations and increases or decreases in various balance sheet accounts and showing financial resources used for dividends and increases or decreases in other balance sheet accounts. The total amounts reported as financial resources provided and used and, indeed, the entire statement are viewed by most preparers and users of bank financial statements as satisfying a disclosure requirement of generally accepted accounting principles but providing little meaningful information. The Committee on Banking of the American Institute of Certified Public Accountants (AICPA) has reviewed current reporting practices in this area and has developed this proposed statement of position setting forth its observations and conclusions.

BACKGROUND

2. Banks, like other commercial enterprises, have been required to report changes in financial position as a separate basic financial statement since 1971, when the Accounting Principles Board (APB) of the AICPA issued Opinion No. 19, Reporting Changes in Financial Position. This reporting requirement provides information on changes in financial resources, defined as working capital by some entities and as cash or cash equivalents by other entities.

3. The Financial Accounting Standards Board (FASB) undertook a project to study funds flows and related matters several years ago and issued a discussion memorandum entitled Reporting Funds Flows, Liquidity, and Financial Flexibility in December 1980. This discussion memorandum included a separate chapter on special considerations for banks and insurance companies that raised certain issues unique to banking operations. The issues include—

- Usefulness of funds statements for banks.
- Definition of funds for banks, including—

  Usefulness of information on gross cash inflows and outflows.

  Usefulness, availability and reliability of information on net changes in balance sheet accounts based on period-end balances or average balances.

- Disclosure considerations for banks in reporting liquidity and financial flexibility.

4. After considering the responses to this discussion memorandum, the FASB issued an exposure draft of a concepts statement entitled Reporting Income, Cash Flows, and Financial Position of Business Enterprises in November 1981. The exposure draft emphasizes the importance of information on cash flows for

commercial enterprises but does not address the above-mentioned banking issues. The Financial Executives Research Foundation recently published a major research study on reporting cash flows.* The FASB has begun a project that is expected to amend or replace APB Opinion No. 19 to require a cash flow statement rather than some other kind of funds statement. As part of that project the FASB plans to consider the applicability of cash flow statements to banks and other intermediaries.

5. Beginning in 1976, the Securities and Exchange Commission (SEC) has required considerable supplemental disclosures by bank holding companies. These requirements, now incorporated in Securities Act Industry Guide 3, Statistical Disclosure by Bank Holding Companies, include information with respect to type, geographic location, quality, maturity, and interest rate sensitivity of major categories of bank assets and liabilities.

6. The reporting requirements of the federal banking regulators (Office of the Comptroller of the Currency, Federal Reserve Board, and Federal Deposit Insurance Corporation) have been expanded to include much of the information required currently by the SEC. Additionally, the banking regulators have issued definitions of primary capital and total capital and have prescribed minimum capital requirements for banks.

7. Recognizing the evolving nature of the FASB and regulatory disclosure requirements and the perceived inadequacies of the traditional bank funds statement, the Committee on Banking decided to address the funds statement and related disclosure matters as a separate project. Accordingly, the sample bank financial statements in the revised 1983 AICPA Industry Audit Guide, Audits of Banks, include a statement of changes in financial position prepared in the traditional manner. The preface to the guide states that this is one of several areas currently under study.

DISCUSSION OF ISSUES

Nature of banking

8. Banks are financial intermediaries. They gather the accumulated cash savings of individuals, corporations, governmental bodies, and other entities and redeploy those savings in the form of loans and investments. In this process, banks must maintain sufficient liquidity to meet withdrawals by depositors, liability maturities, and loan demands of customers. Funds to meet these requirements come from a combination of sources including depositors, money market operations (that is, the "purchase" of funds in the form of various short-term money market instruments), issuance of long-term debt and equity securities, loan repayments, investment sales and maturities, and operations.

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*Allen H. Seed III, The Funds Statement: Structure and Use (Morristown, N.J.: Financial Executives Research Foundation, 1984).

9. In return for providing the services of a financial intermediary and assuming certain related risks, banks expect to earn a profit. This profit arises in part from the spread, or net interest income, between interest income on loans and investments and interest expense on deposits, borrowed funds, and long-term debt.

10. As financial intermediaries, banks assume liquidity risks, credit risks, and interest rate risks. Bank managements have developed various control procedures, techniques, and reports to contain and monitor these risks, thereby limiting the bank's exposure to loss. Investors, creditors, and other third parties relying on bank financial reporting also have an interest in relevant data pertaining to these risks. This data includes information on funds flows, liquidity, and financial flexibility.

11. In view of the nature and complexities of banking operations, relevant information on funds flows, liquidity, and financial flexibility can best be obtained from a combination of bank disclosures.

Statement of changes in financial position

12. Most preparers and users of bank financial statements agree that statements of changes in financial position of the type illustrated in Audits of Banks provide information of limited usefulness. The Committee on Banking shares that view. However, since the statement is currently a requirement of generally accepted accounting principles, the committee believes that the usefulness of the statement may be improved, at least to a limited extent, by reformatting the statement. Exhibit 1 sets forth the suggested format for a statement of changes in financial position. The primary format recommendations include the following:

- The statement should emphasize financial resources invested in earning assets. Bank balance sheets are not classified, and thus working capital is not applicable. Likewise, cash is, in effect, the "product" of banking activities. Aside from its value as a source of liquidity and as satisfaction of reserve requirements, uninvested cash represents a drag on bank earnings. On the other hand, the amount of funds invested in earning assets is relevant information in understanding a bank's operations.

- Related banking activities should be grouped together. Financial resources provided by operations should be presented together; deposits and other financing activities should likewise be grouped in a manner showing both short-term and long-term borrowings and equity security sales; and nonearning investments of financial resources (for example, uninvested cash and premises and equipment) should be grouped together.

13. In developing this format, the committee has noted certain implementation issues, which have been dealt with as follows:

- Noncash charges (credits) to income - The committee has concluded, based on materiality, that only certain major noncash items should be recognized and that the total of such items rather than the individual amounts is sufficient. However, if noncash items are individually material, they should be disclosed separately. Generally such items would include the provision for loan losses, deferred income taxes, and depreciation. Interest credited to savings accounts has historically represented a noncash charge to income provided such interest is not subsequently withdrawn by the depositors. The committee believes the assumption may not be valid during periods of high interest rates and competition for funds among banks, thrift institutions, money market funds, and other financial institutions. Accordingly, the committee recommends that banks not treat interest as a noncash charge unless an evaluation of current and anticipated future patterns with respect to the withdrawal of such interest supports the treatment.

- Sales of common and preferred stock - The committee recognizes that a bank may regard the sale of equity securities as an alternative financing option to the sale of certain types of long-term debt securities. This option is generally considered in the context of satisfying bank regulatory capital requirements, which can be met by certain debt obligations in addition to equity securities. Accordingly, sales of equity and debt securities may be grouped in the statement, at least to the extent that they both satisfy bank regulatory capital requirements. The committee has decided to present equity sales and debt sales with financing activities.

- Use of average balances rather than period-end balance sheet amounts - The committee recognizes that spot balances in balance sheet accounts can change significantly from one day to the next and, therefore, that changes in period-end balance sheet amounts may not be useful. This problem has resulted in the use of balance sheet average amounts for public reporting purposes in much of the supplemental data provided to satisfy SEC requirements and to discuss and analyze a bank's operating results. However, the committee believes that the availability and reliability of average balance information has not yet been developed to the point that it should be incorporated as a part of banks' required primary financial statements. Accordingly, the recommended format in exhibit 1 is based on changes in year-end balance sheet amounts.

Liquidity and financial flexibility

14. As previously discussed, SEC Guide 3 requires bank holding companies to disclose a considerable amount of supplemental statistical information. Much of that information is relevant to an understanding of a bank's liquidity and financial flexibility. The information must be presented for periods ranging from one to five years depending on the category of disclosure and the size of the bank holding company and includes—

- Average balances, interest income and expense, and average interest rates.

- Changes in net interest income resulting from changes in volume versus rates.

- o Investments and loans by type.
- o Investments and loans by maturity.
- o Loans by fixed versus floating interest rates.
- o Average assets and liabilities and earnings data for foreign operations, if significant.
- o Nonaccrual and reduced-rate loans and loan loss data.

15. An increasing number of bank holding companies have chosen to disclose additional information pertaining to the interest rate sensitivity of their assets and liabilities. Such information is frequently presented in the form of an interest rate sensitivity table. Such a table (illustrated in exhibit 2) analyzes interest-earning assets and interest-bearing liabilities by fixed-rate time periods and generally shows the interest sensitivity gap between assets and liabilities for each period. Other banking institutions, instead of disclosing interest rate sensitivity data in a table, have provided relevant information in either narrative disclosures or in graphic form. The committee believes that such information is particularly useful in understanding a bank's exposure to interest rate risks and encourages the disclosure of interest rate sensitivity.

SUMMARY OF RECOMMENDATIONS OF THE COMMITTEE ON BANKING

16. The AICPA Committee on Banking recommends the following:

- o The sample statement of changes in financial position on page 144 of the AICPA Industry Audit Guide, Audits of Banks, should be revised in conformity with exhibit 1.
- o Supplemental disclosure of information on liquidity and financial flexibility is encouraged outside of the basic financial statements. Such information should be drawn from data currently required by the SEC as outlined above, together with interest rate sensitivity data. Presentation of such data in a table should be optional. If tables are used, a brief definition of terms should be provided, as well as a discussion of any items that affect interest rate sensitivity but that are not included in the table detail, such as financial futures or interest rate swaps.

EFFECTIVE DATE AND TRANSITION

17. The committee recommends that the provisions of this proposed statement of position should apply to bank statements of changes in financial position and supplemental information for periods ending on or after December 31, 19__. Comparative financial statements and supplemental information should be restated to comply with the provisions of this proposed statement of position.

EXHIBIT 1

SAMPLE BANK
STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEARS ENDED DECEMBER 31, 19X2 AND 19X1

	19X2	19X1
	(In thousands)	
Financial resources were provided by (applied to):		
Operations:		
Net income	$1,435	$1,331
Noncash charges (credits) - Provision for depreciation, loan losses, deferred income taxes	323	343
Financial resources provided by operations	1,758	1,674
Cash dividends declared	(321)	(321)
Net financial resources provided by operations	1,437	1,353
Deposits and other financing activities:		
Deposits		
Demand	(4,634)	(2,521)
NOW	7,107	
Savings	(3,314)	(1,210)
Time	1,693	2,087
	852	(1,644)
Short-term borrowings	(279)	1,721
Subordinated debentures		1,000
Common stock issued	500	500
Total financial resources provided by deposits and other financing activities	1,073	1,577
Other activities - (Increase) decrease in nonearning assets and liabilities:		
Cash and due from banks	(73)	(129)
Premises and equipment, net	(473)	(315)
Other, net	(1,367)	959
Total financial resources (applied to) provided by nonearning assets	(1,913)	515
Increase in financial resources invested in earning assets	$ 597	$3,445
Increase (decrease) in earning assets:		
Interest-bearing deposits in banks		$ 500
Federal funds sold and securities purchased under reverse repurchase agreements	$2,100	
Trading account securities	(1,275)	2,850
Investment securities	(5,833)	(3,248)
Loans	4,821	2,983
Lease financing	784	360
Increase in earning assets	$ 597	$3,445

Note: This exhibit is based on the sample bank financial statements appearing in Appendix A of the AICPA Industry Audit Guide, Audits of Banks. Captions should be revised based on current balance sheet classifications.

SAMPLE BANK
INTEREST RATE SENSITIVITY TABLE
DECEMBER 31, 19X2

(In thousands)

	Within one year*	After one year but within five*	After five years*	Noninterest-earning/ bearing assets/ liabilities/equity	Total
Assets:					
Interest-bearing deposits	$ 925	$ 60	$ 15		$ 1,000
Investment securities	23,759	7,109	6,827		37,695
Loans and lease financing	18,958	14,429	17,096		50,483
Other assets	6,749	5		$ 9,273	16,027
Total assets	50,391	21,603	23,938	9,273	105,205
Liabilities and stockholders' equity:					
Interest-bearing deposits	69,505	697	114		70,316
Borrowed funds	2,279				2,279
Long-term debt			1,000		1,000
Demand deposits				19,427	19,427
Other liabilities	1,810			345	2,155
Stockholders' equity				10,028	10,028
Total liabilities and stockholders' equity	73,594	697	1,114	29,800	$105,205
Interest rate sensitivity gap	($23,203)	$20,906	$22,824	($20,527)	

*The time periods refer to when the interest rate changes or when the asset or liability can be repriced, not to the maturity date.

Note: Major assumptions used in the preparation of the table should be disclosed. Disclosure should also be made of any off-balance sheet transactions that affect interest rate sensitivity, such as financial futures and interest rate conversion agreements.